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Redistribution in the Private Retirement System: Who Wins and Who Loses?

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INTRODUCTION

Misconceptions and confusion abound in political discourse, academic literature, and the media regarding redistribution in the federal income tax system. This is particularly true of recently proposed tax changes. Concern about the re-distributional impact of some of the new tax proposals has sparked debate and criticism about the equity and effectiveness of tax law and its underlying policies. Critics and pundits often use vague notions of redistribution regarding a particular provision as a basis for determining the fairness and effectiveness of the tax system. However, such assessments are usually limited to quick sound bites and catchy phrases rather than a comprehensive analysis of tax law and the special programs it supports. The former method is seriously flawed and misleading, as it arbitrarily evaluates the impact of a single tax provision without considering the tax system historically and holistically. Furthermore, because such tactics are frequently designed to elicit "knee jerk" reactions rather than careful and thoughtful consideration, they are distracting from a meaningful discussion of real issues and solutions regarding the tax system. Thus, it is not uncommon for the success or failure of certain tax proposals to be unduly influenced by distorted perceptions of re-distributional consequences.

This has been the case for many of the recent proposals that give low and moderate-income taxpayers tax cuts, college loans, and a universal health care system.[1] As a means of paying for the new programs, the proposals also call for increasing the tax burdens of high-

1. *See* Office of Tax Policy, Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals 1 (2009), http://www.treasury.gov/offices/tax-policy/library/grnbk09.pdf [hereinafter *Green Book*] (proposing to make permanent the "Making Work Pay" 6.2% refundable tax credit phased-out at 1.6% for taxpayers with Adjusted Gross Income (AGI) over $75,000 and $150,000 for joint filers); *id.* at 2-3 (expanding eligibility for the Earned Income Tax Credit); *id.* at 4-5 (expanding the refundability of the child tax credit for low and middle income earners); *id.* at 10-11 (replacing the Hope Credit with the American Opportunity Tax Credit, which provides a partially refundable tax credit covering the first four years of post-secondary education and phasing out "for taxpayers with adjusted gross income between $80,000 and $90,000 . . . $160,000 and $180,000 if married filing jointly."); *see also* Office of Mgmt. & Budget, Executive Office of the President, A New Era of Responsibility: Renewing America's Promise 61 (2009), *available at* http://www.gpoaccess.gov/USbudget/fy10/pdf/fy10-newera.pdf (expanding Pell Grants and tying their increase to inflation as well as proposing ways of stabilizing low-cost direct federal loans for undergraduate and graduate level education); The Obama Plan: Stability & Security for All Americans, http://www.whitehouse.gov/issues/health-care/plan (last visited Jan. 29, 2010) (providing tax credits to help low and middle class taxpayers purchase insurance).

income taxpayers.[2] Although the charges made by some critics that the proposed changes create "class warfare," excessively burden the wealthy, and are "socialist" in design may have significant rhetorical flare, they lack normative substance and essential context.[3]

Despite the recent focus on redistribution, it is not a new concept in tax policy. Throughout its history, the tax system has been used as a means of wealth redistribution.[4] Furthermore, contrary to popular perception, more often than not redistribution has occurred from low to high-income taxpayers rather than the other way around.[5] This is especially true of the major asset building programs advanced through the tax system. Historically, asset-building programs that encourage activities such as retirement savings, home ownership, and various forms of investment have benefited high-income taxpayers and given very little benefit to low-income taxpayers.[6] However, the public pays

2. *See* Patient Protection and Affordable Care Act, H.R. 3590, 111th Cong. § 9015 (2009) (adding to FICA's Hospital Tax, 26 U.S.C. § 3101(b) (2004), a 0.5% tax on all wages for taxpayers filing a joint return showing over $250,000 in adjusted gross income or $200,000 on other returns); Affordable Healthcare for America Act, H.R. 3962, 111th Cong. § 551 (2009) (providing for the addition of §59C to the Internal Revenue Code, which would impose "a tax equal to 5.4% of so much of the modified adjusted gross income of the [taxpayers filing jointly] as exceeds $1,000,000," or $500,000 for a taxpayer filing individually); *see also* H.R. 3590, *supra*, at § 9001 (providing for a 40% excise tax on the value of health benefits in excess of $8,500 for individual coverage and $23,000 for spouse or family coverage. Presumably, such "Cadillac" plans are only provided to highly compensated individuals); *Green Book*, *supra* note 1, at 73 (proposing to reinstate the 39.6% tax rate for income exceeding $372,950, indexed for inflation); *id.* at 74-77 (proposing to reinstate the 36% tax rate, limiting itemized deductions; reinstate the personal exemption phase-out; and impose a 20% tax rate on dividends and capital gains for individual taxpayers making $200,000, and imposing the same for married taxpayers who file jointly with income over $250,000).

3. *See, e.g.*, Lori Montgomery, *In Obama Tax Plan, A Shift of Wealth from the Top Down*, WASH. POST., Mar. 7, 2009, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/03/06/AR2009030603367.html.

4. *See* Ajay K. Mehrotra, *"Render Unto Casear . . .": Religion/Ethics, Expertise, and the Historical Underpinnings of the Modern American Tax System*, 40 LOY. U. CHI. L.J. 321 (2009) (exploring the religious and ethical reasons driving the growth of a progressive tax system and social-policy based spending/expenditures in the nineteenth, twentieth, and twenty-first centuries).

5. *See* Jeff Kolnick & Doug Anderson, *Examining "Redistribution of Wealth"*, NAT'L VOTER, Feb. 2009, at 6, *available at* http://www.lwv.org/AM/Template.cfm?Section=Curent_Issues&ContentId=12682&Template=/cm/ContentDisplay.cfm; *Warren Buffett and NBC's Tom Brokaw: The Complete Interview* (NBC Nightly News television broadcast Oct. 31, 2007), *available at* www.cnbc.com/id/21553857 (providing an excellent anecdotal explanation of how payroll and income taxes work together to ensure that the super-wealthy pay a significantly smaller percentage of their total income to the federal government than almost any other category of earner).

6. CORP. FOR ENTER. DEV., HIDDEN IN PLAIN SIGHT: A LOOK AT THE $335 BILLION FEDERAL ASSET-BUILDING BUDGET 12-13 (2004), http://cfed.org/assets/documents/publications/Hidden%20in%20Plain%20Sight%20Summary.pdf (reviewing tax expenditure data for home ownership, retirement accounts, savings and investments, and small business development, the CFED study found that the average benefit to a taxpayer with income in the top 1% is $38,107,

relatively little attention to the distributional impact of these programs.

A recent study commissioned by the Federal Reserve System analyzing the largest of these asset building programs for fiscal year 2005 showed that over 45% of the benefits derived from these initiatives went to taxpayers with incomes over $1 million.[7] The average annual benefit received by these individuals was $169,150.[8] Not surprisingly, many of these tax policies have had, and continue to have, a profound and cumulative effect on the growth of individual wealth in this country.[9] Although all taxpayers, including the least wealthy, subsidize the preferential tax treatment of the savings initiatives by paying higher taxes on the portions of their incomes that do not receive special tax treatment, not all taxpayers receive commensurate levels of benefits from such programs.[10] Therefore, any serious discussion of the distributional aspects of the tax system should consider the impact of one or all of these special initiatives. Even if some of the recent proposals do, to some extent, redistribute income from the rich to the poor, they do very little to offset the regressive effect of these long standing programs.

Unquestionably, encouraging savings and investment is sound tax policy because increased wealth strengthens both the individual and society. To achieve greater equity and effectiveness with respect to these programs and justify their enormous costs, however, the tax incentives for asset ownership should be structured broadly enough to benefit both rich and poor taxpayers. With this objective in mind, it would seem that the new proposals of the current Administration,

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which is seven times the average benefit of the next 4% of the population; 12 times the average benefit of the next 5% after that; 220 times the average benefit of the middle 20%; and 8,985 times the average benefit of the bottom 20%, who receive, on average, a benefit of $4).

7. LILLIAN WOO & DAVID BUCHHOLZ, SUBSIDIES FOR ASSETS: A NEW LOOK AT THE FEDERAL BUDGET 1 (2007) [hereinafter WOO & BUCHHOLZ], *available at* http://community-wealth.com/_pdfs/articles-publications/individuals/paper-woo-bucholz07.pdf ("This report was commissioned as part of the Federal Reserve System/CFED Research Forum on Asset-Building, and first presented at the 2006 Asset Learning Conference in Phoenix, Arizona.").

8. *Id.*

9. *See* Kolnick & Anderson, *supra* note 5.

10. *See* Tax Fairness and Deficit Reduction Act, H.R. 1215, 104th Cong. (1995); *see* Joseph S. Coyle, *How to Beat the Squeeze on the Middle Class You Will Have to Work Longer, Harder, and Smarter. But Follow Our Advice and You Can Move Ahead*, MONEY MAG., May 1, 1995, at 106, *available at* http://money.cnn.com/magazines/moneymag/moneymag_archive/1995/05/01/202720/index.htm (explaining that individual savings rates among the lower- and middle-income taxpayers are in decline); *see also* AARP, AGING BABY BOOMERS: HOW SECURE IS THEIR ECONOMIC FUTURE? 4 (1994) (providing that accumulated savings of the middle class is so low that it will likely not keep pace with projected future needs).

rather than going too far, do not go far enough to reduce overall regressivity in the tax law.

This article evaluates the distributional impact of recent trends in the private retirement system—the largest of the asset building programs[11]—in order to give greater context to the ongoing discussion of redistribution in the tax programs and to recommend policy changes to achieve greater equity in the private retirement system. Evaluating one of the nation's largest and most expensive tax expenditure programs will show not only where the assets are spent and who currently benefits from them, but also how resources should be redirected to better accomplish the objectives of the program.

Specifically, Part I describes the role of tax expenditures in the tax law and analyzes their use in connection with the private retirement system. Part II then demonstrates how and the extent to which existing retirement policies disproportionately benefit the wealthiest taxpayers and provides insufficient protection to low and moderate-income taxpayers against the risk of losses in popular forms of retirement savings plans.[12] Finally, Part III recommends modifications to the tax law that expand the retirement program to benefit a greater number of low and moderate-income taxpayers at each stage of the retirement savings process, in order to achieve greater equity and effectiveness in the tax system in general, and the private retirement system in particular.

I. FEDERAL INCOME TAX POLICY

American tax law contains numerous financial assistance programs that are designed to encourage activities consistent with certain public policy objectives and to relieve various forms of personal hard-

11. *See infra* notes 39-41 and accompanying text.

12. These policies have disparate impact with respect to gender and race, as well. Despite their value to a discussion on retirement equity, gender and racial inequalities regarding the impact of tax incentives for retirement plans are beyond the scope of this article. However, for interesting scholarship specifically addressing these matters, see ARIEL EDUC. INITIATIVE & HEWITT ASSOCIATES, 401(K) PLANS IN LIVING COLOR: A STUDY OF 401(K) SAVINGS DISPARITIES ACROSS RACIAL AND ETHNIC GROUPS (2009), http://www.hewittassociates.com/_MetaBasicCMAssetCache_/Assets/Articles/2009/arielhewitt_401k_study_results.pdf; Ruth Helman, Jack VanDerhei & Craig Copeland, *Minority Workers Remain Confident About Retirement, Despite Lagging Preparations and False Expectations*, 306 EBRI ISSUE BRIEF (2007), *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_06-20079.pdf; SUNWHA LEE & LOIS SHAW, GENDER AND ECONOMIC SECURITY IN RETIREMENT (Inst. for Women's Policy Research 2003), *available at* http://www.iwpr.org/pdf/D456.pdf.; ANNIKA E. SUNDEN & BRIAN J. SURETTE, GENDER DIFFERENCES IN THE ALLOCATION OF ASSETS IN RETIREMENT SAVINGS PLANS (Fed. Reserve Bd. 1998), http://www.federalreserve.gov/PUBS/oss/oss2/papers/gender.pdf.

ship.[13] These provisions represent a set of societal beliefs that some activities are so important that they warrant public subsidies.[14] Rather than offering the subsidies through a single comprehensive system, however, they are provided through a vast and varied assortment of special programs. Some of the special programs are funded by direct payments from the federal government, such as grants, loans, interest subsidies, and federal insurance, but most of them are structured as "tax expenditure" programs.[15]

A. The Tax Expenditure Concept

Broadly speaking, the term "tax expenditure" describes any reduction in a taxpayer's income tax liabilities that results from a special

13. *See, e.g.*, 26 U.S.C. § 108(a)(1)(E) (2006). Though discharged indebtedness is specifically included in the internal revenue code's definition of gross income, 26 U.S.C. § 61(a)(12) (2006), discharge through mortgage restructuring on a qualified mortgage before January 1, 2013 is excluded from a taxpayer's income. The provision at § 108(a)(1)(E) was added by the Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142 (2007), specifically to provide relief to families experiencing personal hardship because of the mortgage crisis. 153 CONG. REC. S15,642-02 (2007) (statement of Sen. Stabenow); *see also Green Book*, *supra* note 1, at 1 (explaining that the reason for the Making Work Pay credit is that it "partially offsets the regressivity of the Social Security payroll tax. . . . [and] effectively raises the income of workers eligible for the credit, which encourages individuals to enter the labor force"); *id.* at 3 (explaining that the expansion of EITC by extending marriage penalty relief will remove "financial impediments to marriage for some low-income households"); *id.* at 6 (proposing to make the Saver's Credit refundable specifically in order "to more effectively encourage moderate- and lower-income individuals to save for retirement"); OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2009 REVENUE PROPOSALS 8 (2008), http://www.treas.gov/offices/tax-policy/library/bluebk08.pdf [hereinafter *Blue Book*] (proposing to expand tax-preferred savings vehicles and eliminate restrictions on certain tax-preferred accounts in order to simplify and encourage the savings process); *id.* at 14-15 (proposing to simplify non-discrimination tests for ERISA qualified retirement accounts and eliminate the test where non-highly compensated employees contributed at 6% in order to "reduc[e] unnecessary complexity [in order to] save significant compliance costs and . . . encourage additional coverage and retirement saving.").

14. WOO & BUCHHOLZ, *supra* note 7, at 2; JOINT COMM. ON TAXATION, JCX-37-09, A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 9-10 (May 12, 2008), *available at* http://www.jct.gov/x-37-08.pdf. The Joint Committee recently explained a new approach to tax expenditure analysis, which provides a "revised classification of tax expenditures . . . into two main categories: . . . 'Tax Subsidies,' and . . . 'Tax-Induced Structural Distortions.'" *Id.* at 9. The new approach seeks to remove the old, hypothetical "normal" tax from the identification of a tax expenditure. *Id.* Instead, "a specific tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law," a traditionally narrow view of tax expenditures, is deemed to be a tax subsidy. *Id.* at 10. Alternately, "structural elements of the Internal Revenue Code," like the deferral of foreign earnings, are Tax-Induced Structural Distortions, "because there is no clear consensus as to what general rule of tax law, if any, [such provisions] might violate." *Id.*

15. The tax expenditure is a concept developed by the late Professor Stanley S. Surrey, who served as Assistant Secretary of the Treasury for Tax Policy in the Kennedy and Johnson administrations. For an in-depth discussion, see STANLEY SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (1973).

tax provision for a designated activity.[16] The term "tax expenditure" is explicitly defined in the Budget and Impoundment Control Act of 1974 ("Budget Act") as "revenue losses attributable to provisions of the federal tax law" that allow preferential tax treatment.[17] Thus, the determination of whether a provision is considered a tax expenditure depends on whether it is viewed as being consistent or inconsistent with generally accepted measurements of net income.[18]

Tax expenditures exist in a variety of forms. There are, for example, exclusions and deductions from income, credits against a taxpayer's tax liability, favorable tax rates on income, and deferral of the payment of certain tax liabilities.[19] The number of provisions classified as tax expenditures has climbed steadily in recent years. Legislation enacted in 2005 alone created seventy new tax expenditure programs for fiscal years 2006-2010.[20] The report for fiscal years 2008-2012 classified more than 170 existing programs as tax expenditures.[21]

Tax expenditure programs are very expensive. Estimates of the cost of tax expenditures are prepared annually for use in the budgetary process, with each tax expenditure being estimated separately. The cost of a given tax expenditure is calculated by measuring the difference between what the tax liability is under current law and what it would have been in the absence of a particular tax expenditure provision, assuming that all other tax expenditures remain in the tax code.[22] According to a recent Joint Committee estimate, the federal

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16. *Id.* at 30-31 (explaining that there are two types of provisions in the tax law, those that comprise the "structural provisions that are necessary to implement the income tax" in contrast to tax expenditure provisions that advance "governmental assistance programs [are] carried out through special tax provisions.").

17. Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344 § 3(a)(3) (1974).

18. *See* PHILIP D. OLIVER, TAX POLICY 682 (2d ed. 2004) (providing that the Haig-Simons income tax baseline method is an accepted method for computing annual tax expenditures).

19. *See supra* notes 15, 17.

20. This number includes programs that were extended. JOINT COMM. ON TAXATION, JCS-2-06, ESTIMATES OF TAX EXPENDITURES FOR FISCAL YEARS 2006-2010, at 30-42 (2006) [hereinafter *JCT Estimates 2006-2010*], *available at* http://www.jct.gov/s-2-06.pdf. This number excludes the programs that were extended. *Id.* at 43; *see* PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION 361 (6th ed. 2008).

21. *See* JOINT COMM. ON TAXATION, JCS-2-08, ESTIMATES OF TAX EXPENDITURES FOR FISCAL YEARS 2008–2012, at 43 (2008) [hereinafter *JCT Estimates 2008-2012*], *available at* http://www.jct.gov/s-2-08.pdf. The Joint Committee Staff report for fiscal years 2008-2012 lists in excess of 170 different tax expenditure programs. *Id.* This number excludes programs that total less than $50 million over the five-year reporting period. *Id.*; *see* MCDANIEL ET AL., *supra* note 20, at 360.

22. *See* JOINT COMM. ON TAXATION, JCS-3-07, ESTIMATES OF TAX EXPENDITURES FOR FISCAL YEARS 2007–2011, at 20 (2007) [hereinafter *JCT Estimates 2007-2011*], *available at* http://www.jct.gov/s-3-07.pdf; *see* MCDANIEL ET AL., *supra* note 20, at 360.

government will forgo over $739.6 billion in revenues in 2009 because of tax expenditures.[23]

The 1974 Budget Act requires that budgets submitted to Congress contain a special analysis and detailed tabulation of all income tax expenditures.[24] Additionally, the staff of the Joint Committee on Taxation publishes annual reports on tax expenditures.[25] These reports measure forgone revenue in connection with a specific initiative and determine which taxpayers and sectors of the economy benefit most from each program.[26] The Joint Committee report, however, does not make a judgment as a matter of public policy regarding the desirability or effectiveness of a particular tax expenditure.[27]

Tax expenditures are functionally equivalent to direct expenditures, and can be used effectively to encourage certain behavior and to accomplish important social objectives.[28] However, because these initiatives are accomplished through tax preferences in the tax system rather than direct outlays, their design and application present unique challenges and additional costs.[29] First, tax expenditures add adminis-

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23. *See JCT Estimates 2008-2012*, *supra* note 21, at 51; *see also* LEONARD BERMAN, ERIC TODER, & CHRISTOPHER GEISSLER, HOW BIG ARE TOTAL INCOME TAX EXPENDITURES, AND WHO BENEFITS FROM THEM? (Urban Inst. 2008), *available at* http://www.taxpolicycenter.org/UploadedPDF/1001234_tax_expenditures.pdf.

24. *See* OLIVER, *supra* note 18, at 682 (noting Congress' requirement that tax expenditures be compiled and quantified on an annual basis).

25. *See, e.g.*, *JCT Estimates 2008-2012*, *supra* note 21, at 43 (excluding all tax expenditure programs with total costs less than $50 million over the five-year period).

26. *Id.* at 71-73.

27. The Joint Committee writes:

> Tax expenditure analysis can help both policymakers and the public to understand the actual size of government, the uses to which government resources are put, and the tax and economic policy consequences that follow from the implicit or explicit choices made in fashioning legislation. . . . Tax expenditure analysis is (or should be) simply an analytical tool, not a criticism of current law or an expression of a normatively superior alternative tax system. . . . [B]y quantifying . . . the forgone revenues association with [a] tax expenditure, this pamphlet provides policymakers with an analytical framework and with quantitative data that they can employ in judging the merits of each such item. . . . The inclusion in this pamphlet of an item as a tax expenditure . . . is not meant to convey that the provision in any fashion is necessarily problematic in the context of the larger policy issues that Congress considers in fashioning every piece of legislation.

Id. at 1-2.

28. C. Eugene Steuerle & Gilliam Reynolds, *Tax Expenditures: What Is the Tax Expenditure Budget?*, Tax Policy Center Urban Institute & Brookings Institute (July 17, 2009), *available at* http://www.taxpolicycenter.org/briefing-book/background/expenditures/budget.cfm ("Tax expenditures operate essentially like direct expenditures, even though they appear as tax breaks."); *see also Green Book*, *supra* note 1; *Blue Book*, *supra* note 13.

29. JOINT COMM. ON TAXATION, JCX-37-08, A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 57 (2008), *available at* http://www.jct.gov/x-37-08.pdf.

> Tax expenditures generally contribute to the compliance burden of the income tax. Some have suggested that not only do they make the tax system more complex because they require distinctions between subsidized and unsubsidized activities, but also they raise compliance costs, IRS costs of administration, and rates of noncompliance. To the

trative burdens to the Internal Revenue Service. These programs force the Internal Revenue Service to be involved in matters of social policy that are totally unrelated to the agency's primary function of raising revenue.[30] Therefore, using the tax system for such purposes requires the Internal Revenue Service to be responsible for the administration of numerous programs that ordinarily would be within the purview of other departments or agencies.[31] The administration of special initiatives is labor intensive and makes it necessary for the Internal Revenue Service to devote significant resources to compliance and enforcement efforts associated with each program. For example, the Internal Revenue Service must draft regulations to clarify and explain the relevant laws. It also is required to issue rulings, conduct audits, and pursue litigation related to the special programs.[32]

Tax expenditures also add tremendous complexity to the tax law. The rules and regulations relating to these programs do not exist in isolation; they must operate and interface with all of the other provisions of the applicable law. By way of illustration, the Employee Retirement Income Security Act is administered by both the Department of Labor and the Internal Revenue Service, leading to multiple layers of reporting and administrative compliance involving two or three entities (EBSA, IRS, PBGC) and their respective regulations.[33] The interrelationship of these provisions makes it difficult to determine the

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> extent that individuals and businesses must devote resources to tracking tax-preferred activities due to tax expenditures, this raises compliance costs. Refining tax expenditures by better targeting them to their intended beneficiaries may have the unintended consequence of also increasing complexity. Tax expenditures also increase the length of instructions and the time required to complete tax returns.

Id.

30. Internal Revenue Service, *The Agency, Its Mission and Statutory Authority*, http://www.irs.gov/irs/article/0,,id=98141,00.html.

31. For example, programs encouraging home ownership might be better administered by the Federal Housing Administration.

32. McDaniel et al., *supra* note 20, at 362; *see* Christopher Howard, The Hidden Welfare State: Tax Expenditures and Social Policy in the United States 17 (1997) ("Agencies thought to be irrelevant to [tax expenditure administration], notably the Treasury Department and its Internal Revenue Service (IRS), emerge and take center stage."); *see also* Eric T. Laity, *The Corporation as Administrative Agency: Tax Expenditures and Institutional Design*, 28 Va. Tax Rev. 411, 442 (2008) (discussing Congress' delegation of the administration of tax expenditures to the Internal Revenue Service).

33. *See* Employee Benefits Security Administration, *History of EBSA and ERISA*, http://www.dol.gov/ebsa/aboutebsa/history.html ("The Employee Benefits Security Administration is responsible for administering and enforcing the fiduciary, reporting and disclosure provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA)."); Internal Revenue Service, *Tax Information for Retirement Plans Community*, http://www.irs.gov/retirement/index.html (providing links to published guidance, forms, and examination/enforcement information relevant to IRS regulation of retirement plans); Pension Benefit Guaranty Corporation, *Welcome to PBGC*, http://www.pbgc.gov ("PBGC is a federal corporation created by [ERISA that]

extent to which the complexity of the existing tax system is attributable to the income tax itself, or to the administration of various tax expenditure programs.[34] As a consequence, the use of tax expenditures significantly impacts the function of the overall tax system. Another issue raised by the use of the tax system to advance public policy initiatives is whether there is sufficient scrutiny and oversight of these programs as compared to other social programs administered by agencies or departments whose responsibilities are devoted to a specific purpose.[35] Notwithstanding the magnitude of the costs reflected in the tax expenditure budget for tax expenditures, the real costs are significantly understated. They do not account for externalities, such as the complexity they add, and the administrative burdens they impose on the Internal Revenue Service.[36]

Of equal or greater importance, however, is that tax expenditures raise additional concerns regarding the equity and effectiveness of the underlying programs because the structure and utilization of many tax expenditures disproportionately benefit high-income taxpayers. In particular, these initiatives raise the questions of: (1) whether the cost of certain tax expenditures can be justified in view of who benefits most from them; (2) whether, as currently designed, certain tax expenditure programs inappropriately contribute to the increasing economic disparity of individuals in this country; and (3) whether the existing structure of certain tax expenditure programs is appropriate to deliver benefits to low and moderate-income taxpayers? These questions are especially pertinent to the asset-building initiatives administered through the tax law.

B. Asset Building Policies

Because of the importance of saving and the challenges that many individuals face in saving on their own, there are numerous tax expenditures specifically designed to provide incentives for different forms of individual asset building behavior.[37] The impact of each of

protects the pensions of more than 44 million American workers and retirees in more than 29,000 private single-employer and multi-employer defined benefit pension plans.").

34. McDaniel et al., *supra* note 20, at 362; Howard, *supra* note 32, at 17 (positing the controversy surrounding classifications of tax provisions as expenditures).

35. Woo & Buchholz, *supra* note 7, at 2.

36. *See supra* notes 23 & 29.

37. *See generally* Woo & Buchholz, *supra* note 7 (analyzing the impact and gravity of tax expenditures designed to incentive homeownership, retirement savings, general saving and investment, and small business development).

these asset building programs has been extensive, and continues to have a profound effect on the financial stability of American taxpayers. Therefore, as we consider the re-distributional effect of recent tax proposals, it is both useful and necessary to consider the distributional aspects of these programs. It is particularly important to determine not only the cost of the programs, but also who benefits from them, and how well the programs accomplish their intended objectives.

Asset building programs can be divided into four main categories: (1) retirement savings, (2) home-ownership, (3) savings and investments, and (4) small business development.[38] By far, the largest and most costly of these programs is the tax expenditures for the favorable tax treatment of employer sponsored retirement plans.[39] In 2009 alone, the tax expenditure for this program was $128.2 billion.[40] The employee-benefit related tax expenditure as a whole, including both retirement and welfare benefits, reached $348 billion for fiscal year 2009.[41]

38. LILLIAN WOO & DAVID BUCHHOLZ, RETURN ON INVESTMENT? GETTING MORE FROM FEDERAL ASSET-BUILDING POLICIES 2 (Corp. for Enter. Dev., D.C. 2006), *available at* http://www.assetpolicy.org/files/File/return_on_investment.pdf [hereinafter Woo & Buchholz II]. For a discussion of these asset-building policies in the broader context of economic mobility see ADAM CARASSO, GILLIAN REYNOLDS, & C. EUGENE STEUERLE, HOW MUCH DOES THE FEDERAL GOVERNMENT SPEND TO PROMOTE ECONOMIC MOBILITY AND FOR WHOM? 2 (2008) (Pew Charicable Trusts/Econ. Mobility Project), *available at* http://www.economicmobility.org/assets/pdfs/PEW_EMP_FEDERAL_SPENDING.pdf (discussing the impact of certain categories of direct spending and tax expenditures, including "1. Employer-related work subsidies (e.g., 401(k) plans and exclusion of employer contributions for medical insurance premiums and medical care); 2. Homeownership . . . 3. Savings and investment incentives . . . [and] 8. Business incentives and development").

39. Historically, the retirement program is the biggest category of asset building tax expenditures, as well as of all tax expenditures. *See* Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851, 874 (1987). This holds true today. According to the Joint Committee on Taxation's most recent estimates, total retirement expenditures (those for ESOP, Keogh, Defined Benefit, Defined Contribution, and IRAs) will continue to "out-cost" the next largest category of asset building expenditure: traditional housing expenditures (deductions for mortgage interest, property taxes, mortgage insurance premiums, and the exclusion of capital gains on home sales). *See JCT Estimates 2008-2012*, *supra* note 21, 50 tbl.2 (showing 2008 estimates of $121.3 billion for retirement and $109.3 billion for housing; 2009 estimates of $128.2 billion for retirement and $114.4 billion for housing; 2010 estimates of $147.2 billion for retirement and $120.3 billion for housing; and 2011 estimates of $160.6 billion for retirement and $145.8 billion for housing).

40. *See JCT Estimates 2006-2010*, *supra* note 20, at 51-59 tbl.2 (showing tax expenditure estimates in billions allocated to the following programs: Special tax provisions for employee stock ownership plans (ESOPs) 0.5; Deferral of taxation on spread on acquisition of stock under incentive stock option plans and employee stock purchase plans [0.4]; Exclusion of pension contributions and earnings for Keogh plans 9.8; Defined benefit plans 42.8; Defined contribution plans 55.2; Traditional IRAs 15.6; Roth IRAs 3.1; and other IRA deferrals 0.8).

41. EMPLOYEE BENEFITS RESEARCH INSTITUTE, TAX EXPENDITURES AND EMPLOYEE BENEFITS: ESTIMATES FROM THE FY 2009 BUDGET, FACTS FROM EBRI (Emp. Benefit Res. Inst., D.C.) (Feb. 2008), at 1, *available at* http://www.ebri.org/pdf/publications/facts/0208fact.pdf. The

Given the cost, size, and importance of individual asset building policies, one might believe that such programs would benefit a cross-section of the population, but this is not the case. In 2004, the Corporation for Enterprise Development (CFED) conducted a comprehensive study to review the nation's spending and tax policy regarding its asset building programs.[42] The study concluded that benefits from the programs overwhelmingly accrue to very high-income households.[43]

In theory, most tax expenditures are universal in their application and are not limited to a specific sector of the population with respect to income, wealth, or other qualifiers.[44] However, the structure of most special programs, including the asset-building category, disproportionately benefits high-income taxpayers. Over 33.3% of the benefits of tax expenditure programs in 2005 went to 1% of the wealthiest taxpayers, as compared to less than 5% that went to taxpayers with the lowest 60% of income.[45] This result occurs in part because of the progressive tax rate structure of the federal income tax system that makes exclusions, deductions, and tax deferral more valuable to taxpayers with higher marginal tax rates.[46] Also, the types of activities that are encouraged, and the extent to which the preferential tax treatment is available, often favor high-income taxpayers with more disposable income.[47] When tax subsidies are skewed in favor of high-income taxpayers and provide relatively little assistance to low-income taxpayers, they are referred to as upside-down-subsidies because of their perverse effect.[48]

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tax expenditure estimate for employer-based retirement plans for fiscal years 2009-2013 totals $541.3 billion. *Id.*

42. CORP. FOR ENTER. DEV., *supra* note 6, at 1.

43. *Id.* at 2-3.

44. There are programs that utilize income phase-outs to target specific groups, such as the Earned Income Tax Credit ("EITC"). *See* 26 U.S.C. § 32(b) (2006).

45. WOO & BUCHHOLZ, *supra* note 7, at 1.

46. STAFF OF J. COMM. ON TAXATION, A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS, JCX-37-08, 52 (2008) ("Tax expenditure design . . . can have a significant effect on vertical equity [among taxpayers]. For example, tax expenditures formulated as deductions will generally reduce the progressivity of the tax system, by reducing average tax rates more for higher marginal rate taxpayers than for lower marginal rate taxpayers. In contrast, tax expenditures structured as credits would generally increase the progressivity of the tax system. A credit will create uniform incentives and provide uniform benefits to all individuals if it is structured as a refundable credit.").

47. For example, § 121 of the I.R.C. allows taxpayers to exclude as much as $500,000 (joint return) of capital gains on the sale of a principal residence. *See* 26 U.S.C. § 121 (2006).

48. STAFF OF J. COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS, *supra* note 46, at 49 (explaining that the progressivity-reducing impact of such expenditures are "what Stanley Surrey termed the "upside down" subsidy effect of tax expenditures structured as deductions").

Some may argue that the U.S. tax system uses a progressive tax rate structure; therefore, it is both appropriate and desirable for high-income taxpayers to receive greater benefits because they pay more in taxes.[49] However, the CFED study shows that, although the top 1% of earners paid an average tax rate of 22.6%, they received as much as 45.3% of the benefit from certain asset building programs.[50] Thus, high-income households received benefits from such programs at a rate that more than doubled what they paid in income taxes. In contrast, low-income households that presumably need the benefits more, received very low levels of benefits, and rates of return from the same programs.[51]

C. The Ability-to-Pay Concept

One of the fundamental tenants of a just tax is that a taxpayer's tax liability should be correlated in some manner with the taxpayer's ability to pay.[52] The origin of this principle in the United States tax system dates back as far as the Income Tax Act of 1913, where the legislative history explains that the income tax is "levied according to ability-to-pay."[53] The ability-to-pay principle is widely accepted as the most viable and equitable method by which to allocate tax burdens, although reasonable minds differ as to what constitutes appropriate

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49. *See, e.g.*, Curtis S. Dubay, *The Rich Pay More Taxes: Top 20 Percent Pay Record Share of Income Taxes* 1, 2420 WEBMEMO (Heritage Foundation May 4, 2009, *available at* http://www.heritage.org/research/taxes/upload/wm_2420.pdf.

50. WOO & BUCHHOLZ II, *supra* note 38, at 7 ("Of the three largest [individual] asset-building policies—the mortgage interest deduction, the property tax deduction, and preferential rates on capital gains and dividends—over 45% of the subsidies go to the top 1% households, whose average income exceed $1.25 million."). Specifically, with regard to tax benefits for defined contribution plans, the top 10% of earners reap 50% of the benefit. Leonard E. Burman, William G. Gale, Matthew Hall & Peter R. Orzag, *Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts*, 16 THE URBAN INST. 26 (2004), *available at* http://www.taxpolicycenter.org/UploadedPDF/311029_TPC_DP16.pdf. Taxpayers with incomes over $1 million receive an average tax benefit of $4,365, while taxpayers making between $10,000 and $20,000 receive and average of $41. *Id.* at 40.

51. Burman, et al., *supra* note 50, at 9 ("The bottom quintile gets almost no benefit from the income tax exclusion because few people in this category contribute to pensions or IRAs, those who do tend to contribute smaller shares of their income than do higher-income contributors, and the tax benefit person dollar of contribution is smaller, and in some cases worthless, because they face low or zero marginal income tax rates."); *see also* WOO & BUCHHOLZ, *supra* note 7, at 2; WOO & BUCHHOLZ II, *supra* note 38, at 7.

52. *See infra* note 54.

53. Vada Waters Lindsey, *The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 FLA. TAX REV. 1, 7 (2001); ROBERT M. WILLAN, INCOME TAXES: CONCISE HISTORY & PRIMER 139 (1994).

distinctions among taxpayers with differing levels of income.[54] For example, some believe that the ability-to-pay should be based on a proportional or flat tax rate structure, while others believe that it should be based on a progressive tax rate. No one, however, argues for a regressive tax rate schedule.[55] Thus, by the prevailing definitions of fairness, tax policy should make appropriate distinctions among taxpayers having different levels of income, and it should not impose higher tax burdens on those who have less.

The current benefit distribution of the asset building programs is in direct conflict with this well-established principle. The preferential tax treatment of these programs substantially lowers the effective tax rates on the savings and asset accumulation of taxpayers at the highest income levels without comparable reductions for those at the lower levels.[56] Considering the purpose of the asset building programs, this result would appear not only to violate basic concepts of fairness, but also those of simple logic. Taxpayers who have more resources presumably would be able to save in the absence of special initiatives; thus, the tax expenditure is unnecessary for these individuals. Furthermore, because individual asset accumulation is essential for the economic stability of society, all—not just some—taxpayers should be encouraged to save. Consequently, in order to justify the cost of the asset-building programs as well as to accomplish their intended purposes, it is necessary to also make savings assistance available to those who have fewer resources and are unable to save on their own. This is particularly true of the private retirement system, in which contributions of employees and employers alike are encouraged to help ensure the retirement security of today's workers.[57] An examination of who benefits most from this program and how its structure favors certain groups will hopefully encourage policymakers to consider re-structuring the system to be more inclusive of low and moderate-income taxpayers.

54. *See* ADAM SMITH, THE WEALTH OF NATIONS, BOOKS IV-V 416 (Edwin Cannan ed., 1904) ("The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities . . . ."); *see also* Richard A. Musgrove, *Equity and the Case for Progressive Taxation*, *in* THE ONGOING DEBATE: TAX JUSTICE 9, 13-15 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002).

55. *See* Michael A. Livingston, *Blum and Kalven at 50: Progressive Taxation, "Globalization," and the New Millennium*, 4 FLA. TAX REV. 731, 733-37 (2000).

56. This results in a flatter, less progressive tax structure.

57. *See supra* notes 39-41 and accompanying text.

II. FEDERAL INCOME TAX POLICY AND PRIVATE RETIREMENT SYSTEM

Retirement plans that operationally meet the requirements of Internal Revenue Code section 401(a) are said to be qualified plans. The qualified status of a plan entitles employers, as well as plan participants, to substantial tax benefits. The first tax advantage is that the employer receives a current deduction when the contributions are made to the plan, but the employee is not taxed until the contributions are distributed.[58] This treatment is an exception to the general rule that an employer is not permitted to take a tax deduction for salary-related expenditures as an ordinary and necessary business expense before the employee includes the payments in income.[59] The second tax advantage is that income earned on the accumulated contributions is not taxed until distribution.[60] This treatment allows a tax-free build-up of the investment earnings, and is the essence of the favorable tax treatment of qualified retirement plans.[61]

The tax subsidy for retirement savings was introduced in the 1920s.[62] Since that time, retirement assets have grown steadily relative to the economy as a whole. Retirement plans held only 3% of all financial assets in 1950; whereas, in 1984 they held almost 17%.[63] Institutional investors, of which pension funds are the largest category,

58. *See* 26 U.S.C. § 404(a) (2006).

59. *Id.*

> The significance of section 404's matching principle becomes evident when one compares the treatment of qualified and nonqualified plans to be "matched," an employer cannot take tax deductions for payments to its employees until the participants include those payments in their taxable income—that is, until the employees actually receive the compensation promised to them.
>
> Qualified plans, in contrast, are not governed by the matching principle and consequently generate concurrent tax benefits to employers. Although employees are not taxed upon the benefits they receive from the plan until they actually receive them, an employer's contributions to a qualified plan are deductible when paid to the trust. I.R.C. §§ 402(a)(1) & 404(a). Thus, the employer may take an immediate, unmatched deduction for any contribution it makes to a qualified plan.

Albertson's, Inc. v. C.I.R., 42 F.3d 537, 543 (9th Cir. 1994).

60. *See* 26 U.S.C. § 501(a) (2006); 26 U.S.C. § 72(t)(2) (2006); 26 U.S.C. § 408(e) (2006).

61. *See* Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506, 519-22 (1986). Although traditional Individual Retirement Arrangements (IRAs) fall outside the qualified plan regime, they receive similar preferential tax treatment, and for some purposes are considered as being an integral part of the private retirement system. *See* Karen C. Burke & Grayson M.P. McCouch, *Lipstick, Light Beer, and Back-Loaded Savings Accounts*, 25 VA. TAX REV. 1101, 1107-08 (2006).

62. Revenue Act of 1921, 42 Stat. 227, § 234 (a)(1) (1921) (providing a deduction for business expenses such as "salaries or other [including deferred] compensation").

63. RICHARD A. IPPOLITO, PENSIONS, ECONOMICS AND PUBLIC POLICY 123-24 (1986).

are the largest holders of American financial assets.[64] Pension fund assets currently total more than $5 trillion and account for almost 50% of all available investment assets in this country.[65]

The preferential tax treatment of qualified plans has been justified as a method of encouraging employers to establish and maintain plans that provide retirement benefits to low-wage employees who may undervalue retirement savings, or find it difficult to save on their own.[66] Notwithstanding the fact that the tax subsidy for qualified retirement plans has been very valuable to high-income individuals and has allowed them to accumulate significant amounts of retirement savings, these plans have been ineffective in either encouraging or increasing the retirement savings among low and moderate-income individuals.

Participation rates among low-income workers in the private retirement system is relatively low, and continues to decline.[67] As of 2008, the overall percentage of workers who participated in employer-sponsored retirement plans was approximately 51%, of which the

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64. Press Release, The Conference Bd., U.S. Institutional Investors Boost Control of U.S. Equity Market Assets (Oct. 10, 2005) (on file with author), *available at* http://www.conference-board.org/UTILITIES/pressDetail.cfm?press_ID=2726. In 2003, institutional investors "controlled $7.974 trillion in equities or 59.2% of outstanding equities in the U.S." *Id.*

65. U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS SEC. ADMIN., PRIVATE PENSION PLAN BULLETIN HISTORICAL TABLES, 10 tbl.E-11 (2008), *available at* http://www.dol.gov/ebsa/pdf/privatepensionplanbulletinhistoricaltables.pdf (reporting total pension plan assets of over $5 trillion in 2005, with $2.25 trillion in defined benefit plans and $2.8 trillion in defined contribution plans); Press Release, The Conference Bd., U.S. Institutional Investors Boost Control of U.S. Equity Market Assets, *supra* note 64. Pension funds owned 40.7% of total U.S. equity assets in 2003, almost double the holdings of either investment companies or insurance companies, and nearly four times bank and trust equity holdings. *Id.*

66. *Pension Parity: Addressing the Inequities Between Retirement Plan Options for Small and Large Businesses: Hearing Before the H. Small Business Subcomm. for Finance and Tax*, 109th Cong. (2007) (statement of Jim McCarthy, Managing Director, Retirement Plan Services Morgan Stanley, on behalf of the Securities Industry & Financial Markets Association), *available at* www.simfa.org/legslative/testimony/pdf/McCarthy10-23-07.pdf; U.S. GOV'T ACCOUNTABILITY OFFICE, INDIVIDUAL RETIREMENT ACCOUNTS: GOVERNMENT ACTIONS COULD ENCOURAGE MORE EMPLOYERS TO OFFER IRAS TO EMPLOYEES, GAO-08-890T (2008), *available at* www.gao.gov/new.items/d08890t.pdf; *see* Burke & McCouch, *supra* note 61, at 1105-07; Letter from James A. Klein, American Benefits Council President, to The President's Advisory Panel on Federal Tax Reform (Apr. 25, 2005) (on file with author), *available at* http://www.americanbenefitscouncil.org/documents/taxreformletter042905.pdf.

67. *See* CONG. RESEARCH SERV., RETIREMENT PLAN PARTICIPATION AND CONTRIBUTIONS: TRENDS FROM 1998 TO 2006, at 7 (2009) [hereinafter RETIREMENT PLAN PARTICIPATION]. From 2003 to 2006, participation rates in defined contribution plans—the most popular type of private retirement plan—dropped from 18.7% to 16.1% among workers with monthly incomes in the third quartile. Workers with monthly incomes in the top quartile consistently report participation rates near or above 60%. *Id.*

largest portion came from the population with the highest income.[68] Almost 70% of workers in the highest quartile, those with income in excess of $65,000, currently participate in employer-sponsored retirement plans; whereas, only 30% of workers in the lowest quartile, those with income under $28,000, participate in these plans.[69] For this reason, some have argued that to the extent that the private retirement system is intended to benefit low and moderate-income employees, the system has failed.[70]

A major reason that the private retirement system is increasingly ineffective in encouraging savings among low and moderate income-workers can be explained by the recent shift from the use of traditional defined benefit plans to defined contribution plans as primary retirement savings vehicles.[71] These popular savings arrangements often require elective contributions by plan participants, making it less likely that low and moderate-income taxpayers will either participate or contribute amounts sufficient for their retirement security. Furthermore, even when such workers do set aside funds for retirement, these savings vehicles fail to provide adequate protection against the inherent investment risks associated with such plans.[72] The lack of protection against plan losses is problematic for all participants, but has a disparate impact on low and moderate-income taxpayers because they have fewer resources from which to draw to make-up the difference.

A. Participation in Section 401(k) Plans Among Low and Moderate-Income Workers

The composition of the private retirement system has changed significantly since the passage of the Employee Retirement Security

68. CONG. RESEARCH SERV., PENSION SPONSORSHIP AND PARTICIPATION: SUMMARY OF RECENT TRENDS, CRS-RL30122, at 4 (2009), *available at* http://assets.opencrs.com/rpts/RL30122_20090911.pdf [hereinafter PENSION SPONSORSHIP]; LANGBEIN, STABILE & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 26 (4th ed. 2007); THE RETIREMENT SECURITY PROJECT, PROTECTING LOW-INCOME FAMILIES' SAVINGS: HOW RETIREMENT ACCOUNTS ARE TREATED IN MEANS-TESTED PROGRAMS AND STEPS TO REMOVE BARRIERS TO RETIREMENT SAVING, RSP POLICY BRIEF 7 (2005), *available at* http://www.retirementsecurityproject.org/pubs/File/Asset-TestReport.final.pdf.

69. PENSION SPONSORSHIP, *supra* note 68, at 11-13.

70. *See, e.g.*, Ross Eisenbrey, Vice President Economic Policy Institute, *Why We Need Retirement USA*, Address to the National Press Club (Mar. 10, 2009), *available at* www.epi.org/publications/entry/why_we_need_retirement_usa/.

71. See *infra* note 79 and accompanying text.

72. See *infra* Part II.B.

Act (ERISA) of 1974.[73] When ERISA was enacted, traditional defined benefit plans were the most common type of retirement plan, and defined contribution plans were used primarily as supplemental savings arrangements.[74] In a traditional defined benefit plan, the plan assets are pooled into an aggregate trust and the participant is guaranteed a retirement benefit of a fixed amount.[75] In such plans, the employer is required to fund the plan sufficiently to pay for the promised benefit and is liable for the payment of the benefit, despite the investment performance of the plan assets. Thus, the employer, rather than the participant, bears the risk of investment losses.[76] To protect defined benefit plans participants in the event that the employer becomes insolvent, the Pension Benefit Guaranty Corporation (PBGC) insures a limited accrued benefit.[77] The maximum insurable benefit is phased in over a five-year period and, for plans terminating in 2010, the benefit equals approximately $54,000 per year for an individual who retires at age 65.[78]

Over the last two decades, there has been a discernable shift from using traditional defined benefit plans as primary retirement savings

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73. Pub. L. No. 93-406, 88 Stat. 829 (1974). ERISA completely revised the legal framework of the qualified pension plan as it had previously existed. *Id.*; *see also Enron and Beyond Enhancing Works Retirement Security: Hearing Before the Comm. on Educ. and the Workforce*, 107th Cong. 9-11 (2002) [hereinafter Enron Hearing] (statement of Dr. Jack L. VanDerhei, Ph.D, Healthcare Management, Temple University and EBRI Fellow); *see* RICHARD IPPOLITO, PENSION PLANS AND EMPLOYEE PERFORMANCE: EVIDENCE, ANALYSIS, AND POLICY 4-5 (1997) (noting that the share of workers covered by defined benefit plans dropped from 83% to 50% from 1979 to 1996). The most significant innovations of ERISA concerned participation, vesting, and funding standards. Regina T. Jefferson, *Striking a Balance in Cash Balance Plan Debate*, 49 BUFF. L. REV. 513, 514 n.1 (2001) [hereinafter Jefferson, *Striking a Balance*].

74. John W. Thompson, *Defined Benefit Plans at the Dawn of ERISA*, Bureau of Labor Statistics (2005), *available at* http://www.bls.gov/opub/cwc/cm20050325ar01p1.htm ([In] "1974, nearly 31 million workers were covered by private pensions, with 27 million [87% of those covered] enrolled in defined benefit plans").

75. The Department of Labor explains:

> A defined benefit plan promises you a specified monthly benefit at retirement. The plan may state this promised benefit as an exact dollar amount, such as $100 per month at retirement. Or, more commonly, it may calculate a benefit through a plan formula that considers such factors as salary and service—for example, 1 percent of your average salary for the last 5 years of employment for every year of service with your employer.

Employee Benefits Security Administration, *FAQs About Pension Plans and ERISA*, http://www.dol.gov/ebsa/faqs/faq_consumer_pension.html.

76. *See* I.R.C. § 412 (2006); Regina T. Jefferson, *Post-Enron Pension Reform: Where Do We Go from Here?*, *in* N.Y.U. REV. EMP. BENEFITS & EXECUTIVE COMPENSATION § 10.02[2], at 10-6 (Alvin D. Lurie ed., 2003) [hereinafter Jefferson, *Post-Enron Pension Reform*].

77. Pension Benefits Guaranty Corporation, Mission Statement, http://www.pbgc.gov (click on the link "Who We Are") (last visited Jan. 13, 2010).

78. Press Release, Pension Benefits Guaranty Corporation, PBGC Announces Maximum Insurance Benefit for 2010 (Oct. 27, 2009), http://www.pbgc.gov/media/news-archive/news-releases/2009/pr10-02.html.

vehicles to using defined contribution plans.[79] In a defined contribution plan, there is no single trust; instead, participants are assigned individual accounts to which the employer makes annual contributions.[80] At retirement, participants receive the balances in their accounts.[81] Thus, the success or failure of these savings programs depends on how much has been contributed, and how well the assets have been invested.[82] Because there is neither a guarantee of a specific amount at retirement nor PBGC insurance, the participant alone bears the risk of investment losses.[83]

The numerous types of plans and features available within defined contribution plans accommodate the preferences and risk tolerances of different employers and employees.[84] The cash or deferred arrangement, better known as the section 401(k) plan, represents the

79. *The Effects of Recent Turmoil in Financial Markets on Retirement Security, Hearing Before the H. Comm. on Education and Labor*, 110th Cong. 2 (2008) [hereinafter *Hearings*] (statement of Peter R. Orszag, Director, Cong. Budget Office) *available at* http://www.cbo.gov/ftpdocs/98xx/doc9864/10-07-RetirementSecurity_Testimony.pdf ("Over the past several decades, the private-sector pension system has shifted dramatically toward defined-contribution plans, such as 401(k) plans."). Specifically, in the twenty years from 1985 to 2006, defined benefit plans fell by 74% and "the number of workers participating in defined benefit plans fell from 27 million in 1985 to 19.5 million in 2008." PENSION SPONSORSHIP, *supra* note 68, at 4.

80. *See* 29 U.S.C. § 1002(34) (2006) (The ERISA definition section, providing that an "'individual account plan' or 'defined contribution plan' [as] a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses" of that participant's account); Edward A. Zelinksy, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 455-58 (2004). Zelinksy explains:

> The distinction between defined benefit and defined contribution plans is surprisingly clear. A defined benefit plan, as its name implies, specifies an output for the participant. . . . In contrast, a defined contribution arrangement, as its equally apt moniker indicates, specifies an input for the participant. Commonly, the plan defines the employer's contribution for each participant as a percentage of the participant's salary for that year. Having made that contribution, the employer's obligation to fund is over because the employee is not guaranteed a particular benefit, just a specified input. In a defined contribution context, the participant's ultimate economic entitlement is the amount to which the defined contributions for her, plus earnings, grow or shrink.

Id. at 455-58.

81. Zelinsky, *supra* note 80, at 455-58.

82. *See* 29 U.S.C. § 1002; Zelinksy, *supra* note 80; *see also Hearings*, *supra* note 79, at 3.

83. *See* 29 U.S.C. § 1002(34); Jefferson, *Post-Enron Pension Reform*, *supra* note 76, at 10-17. From the employer's perspective, the shift from defined benefit plans to defined contribution plans can be explained by the fact that defined contribution plans are less expensive and less administratively burdensome to maintain than defined benefit plans. From the employee's perspective, the popularity of defined contribution plans can be explained by the fact that they provide simpler benefits, and provide greater portability, which allows workers to change employment without experiencing significant reductions in their retirement benefits. For a more extensive discussion of different plan types, see *Enron Hearing*, *supra* note 73, at 3. *See also* LANGBEIN, STABILE & WOLK, *supra* note 68, at 43-55.

84. LANGBEIN, STABILE & WOLK, *supra* note 68, at 45-52 (providing a survey of various defined contribution plans, including money purchase plans, profit-sharing plans, 401(k) and cash-deferred arrangements).

fastest growing type of defined contribution plan, and it dominates new plan offerings in the private sector.[85] As of 2005, contributions to section 401(k) plans alone exceeded the combined contributions made to traditional defined benefit plans and those made to all other defined contribution plans.[86] Section 401(k) plans currently account for as much as 64.2% of all qualified retirement plans and cover 46% of all participating employees.[87] Under these plans, employees elect to have portions of their compensation contributed to qualified retirement plans, rather than receive them as compensation in the year in which they are earned.[88] Although employers are permitted to make non-elective contributions to plan participants, most 401(k) plan contributions are made on behalf of only those employees who elect to participate.[89]

Notwithstanding the preferential tax treatment of contributions to qualified plans, low and moderate-income employees covered by such plans often do not elect to make contributions because they need their disposable income to satisfy current and more pressing expenses.[90] Thus, to encourage greater participation among this group, employers offering 401(k) plans will often provide additional incen-

85. These plans are referred to as section 401(k) plans because this is the section of the I.R.C. that governs such plans. 26 U.S.C. § 401(k) (2006). 401(k) plans have grown from 17,303 plans in 1985 to 436,207 plans in 2005, with a more than twenty-six fold increase in total assets. U.S. DEPT. OF LABOR EMPLOYEE BENEFITS SEC. ADMIN., PRIVATE PENSION PLAN BULL. HISTORICAL TABLES 19 tbl.E20 (2008), *available at* http://www.dol.gov/ebsa/pdf/privatepensionplanbulletinhistoricaltables.pdf [hereinafter PRIVATE PENSION PLAN].

86. PRIVATE PENSION PLAN, *supra* note 85, at 13 tbl.E14, 19 tbl.E20 (showing contributions in millions of $223,533 to 401(k) plans, $92,662 to defined benefit plans, and $25,255 to all other defined contribution plans). 401(k) plans have received the largest share of contributions for over ten years. John B. Shoven & David A. Wise, *Extending the Consumption Tax Treatment of Personal Retirement Savings*, 88 AM. ECON. REV. 197, 197 (1998). In 1998, approximately $100 billion was contributed annually to section 401(k) plans, which represented a 100% increase from 1990. *Id.*

87. Section 401(k) plans account for 426,207 of the 679,095 total qualified plans in 2005 and 54,623,000 of the total 117,406,000 employees who participated in any kind of qualified retirement plan. PRIVATE PENSION PLAN, *supra* note 85, at 1 tbl.E1, 5 tbl.E6, 20 tbl.E21.

88. 26 U.S.C. § 401(k)(2)(A) (2006).

89. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, PRIVATE PENSIONS: LOW DEFINED CONTRIBUTION PLAN SAVINGS MAY POSE CHALLENGES TO RETIREMENT SECURITY, ESPECIALLY FOR MANY LOW-INCOME WORKERS, GAO-08-8, at 8 n.12 (2007), *available at* http://www.gao.gov/new.items/d088.pdf [hereinafter PRIVATE PENSIONS: LOW DEFINED CONTRIBUTION PLAN].

90. *See* U.S. GEN. ACCOUNTABILITY OFFICE, 401(K) PENSION PLANS: MANY TAKE ADVANTAGE OF OPPORTUNITY TO ENSURE ADEQUATE RETIREMENT INCOME, GAO-/HEHS-96-176, at 4-6 (1996), *available at* http://www.gao.gov/archive/1996/he96176.pdf [hereinafter GAO REPORT 1996] (finding that 60% of employees with income less than $25,000 per year have no pension coverage, and subsequently must rely on social security as their only retirement security); *see* Regina T. Jefferson, Comment to *Pensions and Savings–In What Form?*, *in* FRAMING THE SOCIAL SECURITY DEBATE 107 (R. Douglas Arnold et al. eds., 1998); *see also* Anne Willette, *401(k) Plans Benefit the Wealthy*, USA TODAY, Nov. 24, 1997, at 13A.

tives for participation by matching the employees' elected contributions in some form or fashion. For example, the employer may match 100% of the first 1% of pay contributed by the employee and then match 50% of contributions in excess of 1%, up to a specified limit.[91] Even with the prevalence of such incentives, however, less than one half of all workers who earn under $15,000 per year contribute to their 401(k) plans.[92] Additionaly, when these workers do contribute, they tend to contribute smaller percentages of their income than higher-income workers. In 1992, taxpayers with income below $25,000 made contributions of only 3.7% of their income, while taxpayers with income over $75,000 made contributions of 7.9% of their income.[93] Consequently, low and moderate-income workers with 401(k) plans are far less likely to accumulate adequate savings for retirement. In 2008, 54.2% of participating employees earning $20,000 to $40,000 annually saved less than $5,000 in their plans.[94] Such small amounts are grossly inadequate in providing retirement security for these workers.

The Pension Protection Act of 2006 (PPA) introduced various rules designed to enhance retirement savings among low and moderate-income workers in defined contribution plans.[95] These rules include provisions that encourage automatic rollovers, require faster

91. The matching contributions are subject to nondiscrimination rules. *See* I.R.C. § 401(k)(m) (2006); Treas. Reg. § 1.401(k)-1(b)(3) (as amended in 1995); *see also* JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFITS LAW 332-37 (3d ed. 2000).

92. *See* Employee Benefits Research Institute, EBRI Databook on Employee Benefits (1995), http://www.ebri.org/publications/books/index.cfm?fa=databook [hereinafter EBRI Databook].

93. PRIVATE PENSIONS: LOW DEFINED CONTRIBUTION PLAN, *supra* note 89, at 22.

94. *How Well Are Employees Saving and Investing in 401(k) Plans*, HEWITT UNIVERSE BENCHMARKS 2009, at 17, *available at* http://www.hewittassociates.com/Intl/nA/enUs/Knowledgecenter/ArticlesReports/ArticleDetail.aspx?cid=6863&tid=0 (click on "Access a copy of this report," fill out the form on the next screen, and click "next"). In 2001, the average balance in employer sponsored defined contribution plans among moderate and low-income taxpayers approaching retirement was only $10,400. ZOE NEUBERGER, ROBERT GREENSTEIN & EILEEN P. SWEENEY, THE RETIREMENT SECURITY PROJECT, PROTECTING LOW-INCOME FAMILIES' SAVINGS: HOW RETIREMENT ACCOUNTS ARE TREATED IN MEANS-TESTED PROGRAMS AND STEPS TO REMOVE BARRIERS TO RETIREMENT SAVING 7 (2005), *available at* http://www.retirementmadesimpler.org/Library/Protecting%20Low%20Income%20Families'%20Savings%20-%20Full.pdf.

95. Among its many amendments to ERISA, the PPA updated funding and benefit requirements for single and multi-employer benefit plans, made efforts to increase the financial health of PBGC, and provided for greater disclosure of plan information. Pub. L. No. 109-280, 12 Stat. 780 at §§ 101-07, 201-21, 401-12, 501-09 (2006). Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006), made comprehensive changes to ERISA in response to the changing pension landscape. DAVID N. LEVINE & AUGUST A. IMHOLTZ III, INTRODUCTION TO ERISA: A COMPREHENSIVE GUIDE § 1.08 (Paul J. Schneider & Brian M. Pinheiro eds., Aspen Publishers 3d ed. 2008).

vesting, and create safe harbors for automatic enrollment.[96] However, these relatively minor adjustments to the law will not remedy the deficiencies of the existing program, as it relates to the retirement security of low and moderate-income workers. This is because such changes neither alter the structure of the private retirement system nor eliminate disparities in the level of tax benefits enjoyed by low and high-income taxpayers.

The challenge of any retirement savings program is to get money into the participants' accounts, protect the money in the accounts against the risk of loss until retirement, and distribute the expected benefits at retirement. Regarding the first challenge, the existing private retirement system, with its increasing reliance on 401(k) plans as primary retirement savings vehicles, is by many measures ineffective for low and moderate-income taxpayers. Although current pension policy provides a significant tax subsidy to high-income taxpayers, it does not provide a comparable subsidy to low and moderate-income taxpayers. Furthermore, low participation rates among low to moderate-income taxpayers demonstrate that in reality they receive very little benefit from the existing system.

These results suggest that low and moderate-income taxpayers need a different retirement program with different characteristics. An example of such a program is a universal retirement system, such as the one described in Part III of this article. This program requires that all workers be covered by a private plan, and that there be a subsidy for low and moderate-income taxpayers structured differently than that under the present system.

Although a universal retirement system with a subsidy for low and moderate-income workers responds to the first challenge of a retirement savings program by increasing participation among low and moderate- income workers, and by correcting the reverse subsidy ef-

96. Section 902 of the PPA, titled Increasing Participation Through Automatic Contribution Arrangements, amended 26 U.S.C. § 401(k) to provide an automatic enrollment plan, where an employer makes cash or deferred compensation contributions meeting minimum escalation requirements. Pub. L. No. 109-280, § 902(a), 12 Stat. 780 (2006). It also amends 26 U.S.C. § 401(m) by providing a safe harbor for automatic enrollment plans from the nondiscrimination test for matching contributions and employee contributions. Pub. L. No. 109-280, § 902(b). The PPA also provides for faster vesting of non-elective contributions to both defined benefit and defined contribution plans by amending 26 U.S.C. § 411(a). Pub. L. No. 109-280, § 904. As a result, employer contributions to defined benefit plans must either fully vest within five years, or vest at a minimum of 20% per year, beginning within three years. *Id.* Employer contributions to defined contribution plans must either fully vest within three years, or vest at a minimum of 20% per year, beginning within two years. *Id.*

fect, it does not respond to the latter two challenges that involve risk of loss and erosion of the expected retirement benefit. At each stage of the retirement savings process, section 401(k) plans are less effective, and impose greater risks than traditional defined benefit plans. This is especially true for low and moderate-income workers who have fewer resources to protect themselves against plan losses. Thus, the next portion of this article addresses the second and third challenges of a retirement program as they relate to the various risks in 401(k) plans, and the lack of protection against these risks provided under current law.

B. Risk of Loss in Section 401(k) Plans

1. Participant-Directed Plans

Participant-directed plans are a type of 401(k) plan that present an even greater risk than regular 401(k) plans that low and moderate-income workers will not accumulate sufficient amounts for retirement. In participant-directed 401(k) plans, participants, rather than the employer, must decide not only whether to participate and the level of compensation to contribute, but also the manner in which their accounts are to be invested.[97] The law imposes no additional education or notification requirements on employers who sponsor such plans; therefore, participants often make crucial investment decisions regarding their accounts without the benefit of financial training.[98]

Without the benefit of financial professionals to assist in their investment choices, inexperienced investors typically will disproportionately select low-risk, low-yield instruments that fail to maximize

97. The Employee Benefit Research Institute explains:

> There are three different sections of the Internal Revenue Code (IRC) that establish salary-reduction retirement plans, based on the sector of employment [including] 401(k) plans . . . . All of these plans are voluntary (meaning the employer can choose whether or not to offer a plan to its workers) and all are defined contribution plans (meaning they define how much the worker—and the employer, if it chooses to—will contribute to a worker's retirement account). Typically in these types of plans, the worker directs at least a portion of how the contributions will be invested (within the investment options offered by the employer), and bears all the investment risk. Benefits are usually distributed as a lump sum.

Employee Benefit Research Institute, *Fundamentals of Employee Benefit Programs* 81 (6th ed. 2009), *available at* http://www.ebri.org/pdf/publications/books/fundamentals/2009/08_401l-Pls_RETIRMENT_Funds_2009.EBRI.pdf.

98. *See generally* Regina T. Jefferson, *Rethinking the Investment of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 611-12 (2000) [hereinafter *Rethinking the Investment*] (describing the risk of benefit shortfalls inherent to 401(k) plans such as a lack of PBGC protection and fiduciary liability on the part of the employer).

investment-returns over the long-run.[99] A high concentration of such funds is unlikely to produce sufficient investment income over an employee's working life to provide adequate retirement income.[100] Inexperienced investors are not only less likely to adequately diversify their accounts, but also are less likely to recognize financial indicators that investment professionals rely on to determine when to shift funds from one investment to another.[101] Accordingly, some participants may fail to take appropriate measures when changes are indicated by market conditions, acting either too slowly or too hastily.[102] Therefore, because low and moderate-income workers are less likely to have the resources to obtain professional financial assistance or to have prior investment experience, when they do elect to save for retirement, they are exposed to greater risks of loss in participant-directed plans than their higher-income counterparts.[103] As a result, low and moderate-income workers often receive significantly smaller benefits than those they expect, and upon which they have relied.[104]

2. Lump Sums Payments Versus Life Annuities

In traditional defined benefit plans, the normal retirement benefit is expressed as an amount certain, payable at retirement in the form of a qualified joint and survivor annuity (QJSA). A QJSA is an annuity payable for the life of the participant, with at least a 50% survivor

99. *See* Alicia H. Munnell & Annika Suden, *401 (k) Plans Are Still Coming Up Short*, 43 AN ISSUE IN BRIEF 4 (Ctr. For Ret. Research at Boston Coll., Chestnut, Mass.) (Mar. 2006), *available at* http://crr.bc.edu/briefs/401_k_plans_are_still_coming_up_short.html (click on the link for full paper in PDF).

100. *See generally* Jefferson, *Rethinking the Investment*, *supra* note 98, at 611-12 (describing the risk of benefit shortfalls inherent to 401(k) plans such as a lack of PBGC protection and fiduciary liability on the part of the employer). *See also* Susan J. Stabile, *Paternalism Isn't Always a Dirty Word: Can the Law Better Protect Defined Contribution Plan Participants?*, 5 EMP. RTS. & EMP. POL'Y J. 491, 498-501 (2001) ("Many defined contribution plan participants invest too conservatively to ensure sufficient benefits at retirement—disproportionately investing in fixed income alternatives").

101. Jefferson, *Rethinking the Investment*, *supra* note 98, at 628; *see also Diversification Is Key to Success of Section 401(k) Investments, ASPA Told*, 17 PENS. & BEN. REP. (BNA) 1243 (1990) [hereinafter *Diversification*] (discussing that insufficient financial training has been cited most frequently as the explanation for why participants use overly conservative investment strategies).

102. Jefferson, *Rethinking the Investment*, *supra* note 98, at 629.

103. *See* John R. Keville, Note, *Retire at Your Own Risk: ERISA's Return on Investment?*, 68 ST. JOHN'S L. REV. 527, 545-46 (1994) ("The majority of self-directed pension plan investors transferred funds to the stock market after it reached its high in 1987, and bailed out after the market crashed soon thereafter").

104. *See* Regina T. Jefferson, *The American Dream Savings Account: Is it a Dream or a Nightmare?*, *in* TAXING AMERICA 261 (Karen B. Brown & Mary Louise Fellows eds., 1996).

benefit for the surviving spouse.[105] The equivalent form of payment for an unmarried participant is a life annuity.

Life annuities guarantee periodic payments over the life of the participant; consequently, they provide protection against unexpected longevity. Although life expectancy tables can assist individuals in allocating sufficient assets to live comfortably throughout retirement, the tables are inexact. There is substantial variation in life expectancies among different groups relative to race, gender, and income.[106] Therefore, predictors such as life expectancy tables and family history are unreliable. For this reason, life annuities are the most effective method by which individuals can allocate resources over the duration of their lives and protect themselves against the risk of outliving their assets.[107] Accordingly, many economists maintain that life annuities are an essential component of any properly structured retirement portfolio.[108]

Although the pension law requires defined benefit plans to offer life annuities as an optional form of distribution, section 401(k) plans are not required to do so.[109] As a result, lump sum payments are the

105. 26 U.S.C. §§ 401(a)(11), 417(b) (2006). This benefit can be waived by the non-participating spouse. 26 U.S.C. § 417(a)(2) (2000); *see also* 29 U.S.C. § 1055(c)(1)(A)(1)(i) (2010) (allowing spouse to waive interest in joint and survivor benefit); *see* I.R.C. 401(a)(11) (identifying the normal form of payment for married participants as a qualified joint and survivor annuity (QJSA)); LANGBEIN & WOLK, *supra* note 91, at 580, 586; Leon I. Finkel & Hailee R. Bloom, *Changing Pension Beneficiaries After Divorce: It's More Important After Kennedy*, 97 ILL. B.J. 462, 463 n.3 (2009) (discussing spouse's right to waive an interest in ERISA benefits).

106. *See* Jeffrey R. Brown, *How Should We Insure Longevity Risk in Pensions and Social Security?*, 4 AN ISSUE IN BRIEF 5 (Ctr. For Ret. Research At Boston Coll., Chestnut, Mass.) (Aug. 2000), *available at*http://crr.bc.edu/briefs/how_should_we_insure_longevity_risk_in_pensions_and_social_security_.html (Click on the link for full paper in PDF); *see also* NAT'L CTR. FOR HEALTH STATISTICS, CTRS. FOR DISEASE CONTROL AND PREVENTION, HEALTH, UNITED STATES, 2008 WITH SPECIAL FEATURE ON THE HEALTH OF YOUNG ADULTS 48 (2009), *available at* http://www.cdc.gov/nchs/data/hus/hus08.pdf#26. In 2005, "[a]mong men, life expectancy at age 65 [was] 17 years and among women . . . 20 years." Life expectancy for those born in 2005 was "75 years for men and 80 years for women[:] 76 years for white males compared with 70 years for black males and 81 years for white females compared with 77 years for black females." *Id.*

107. *See* Brown, *supra* note 106, at 5 (describing difficulty of predicting life span). To illustrate the value of a life annuity, consider an individual who is age 65, owns significant assets and is preparing for retirement. Further assume that this individual has no Social Security benefits, no private pension payments, and no other source of income. Individual X desires to live in a manner that will allow her to have sufficient assets to live comfortably for the duration of her life. Obviously, if X knew her exact date of death and the rate of return on her investments, it would be a relatively simple exercise to determine how much she should spend annually in order not to deplete her assets before death. However, without this information it is difficult, if not impossible, to allocate her wealth so as to achieve this goal. *See id.*

108. *See* Brown, *supra*, note 106, at 5, 16.

109. *Cf.* 26 U.S.C. §§ 401(a)(9), (a)(11), (g) *and* 415(b) (2006) (regarding the obligation of a defined benefit plan to offer annuities) *with* 26 U.S.C. § 401(k).

most common form of distribution in 401(k) plans.[110] In 2008, only one in five 401(k) plans offered plan participants the option of choosing a life annuity at retirement.[111]

It is possible for individuals receiving lump sum payments at retirement to purchase life annuities independently in the commercial market. However, this form of self-help can be prohibitively expensive for low and moderate-income individuals. Life annuities purchased in the commercial market by individuals typically are more expensive than those offered to participants in qualified plans for two reasons.[112] One reason is that there are no "economies of scale"[113] when individuals purchase life annuities independently. Thus, the profit margins and administrative costs are higher in the commercial market for independently purchased products.[114]

More importantly, because life annuities are most beneficial to individuals who live beyond average life expectancies, companies selling life annuities assume that there is self-selection among those seeking to purchase these products in the commercial market. Companies further assume that those who purchase such products are in excellent health and, based on predictors such as family history, expect to live longer than average lives. These companies determine the cost and payment levels for their products based upon these assumptions. Therefore, the purchase of a life annuity independently in the commercial market can impose a significant loss on low-income individuals because they have less disposable income and below-average life expectancies.[115] As a result, it is reasonable for low-income retirees to conclude that the reduction in their retirement benefits, necessary to cover the costs and fees for a life annuity, would be better spent on more pressing current expenditures. This is the case despite the fact

110. *Immediate Income Annuities and Defined Contribution Plans*, VANGUARD CTR. FOR RET. RESEARCH, (The Vanguard Group, Inc., Valley Forge, Pa.), May 2009, at 4 n.7 (collecting studies reflecting annuity availability between 5% and 20%) *available at* https://institutional.vanguard.com/iam/pdf/CRRADC.pdf. *But see* Accounting Web, *More Employers Offering Annuities as Part of 401(k) Package*, Dec. 22, 2009, http://www.accountingweb.com/topic/cfo/more-employers-offering-annuities-part-401k-package (reporting a 22% offer rate).

111. See sources cited *supra* note 110.

112. PENSION SPONSORSHIP, *supra* note 68, at 30.

113. *See* WILLIAM J. BAUMOL & ALAN S. BLINDER, ECONOMICS PRINCIPLES AND POLICY, G-2 (6th ed., Thompson South-Western 1994) (defining economies of scale as "savings that are acquired through increases in quantities produced").

114. *Id.*

115. Monique Morrissey, *Rich Man, Poor Man: The Life Expectancy Gap* (Economic Policy Institute), Jan. 16, 2008, *available at* http://www.epi.org/economic_snapshots/entry/webfeatures_snapshots_20080116/.

that life annuities provide valuable and highly recommended protection.[116]

Life annuities not only solve the problem of unexpected longevity, but also the problem of "leakage." Leakage refers to the use of retirement funds for purposes other than retirement.[117] Section 401(k) plans provide lump sum payments when participants retire as well as when they terminate employment prior to retirement.[118] These early distributions allow individuals to spend their retirement savings long before reaching retirement. Although the law permits participants who receive pre-retirement lump sum distributions to roll them over tax-free into other qualified retirement plans—or to IRAs—most individuals who receive lump sum distributions from their retirement plans do not reinvest them in this manner.[119] In 2006 alone, retirement accounts lost $74 billion to lump-sum distributions that were not reinvested.[120]

Data shows that the propensity to roll-over varies with the size of the distribution.[121] Distributions of larger amounts are more frequently rolled over than distributions of smaller amounts.[122] Low-in-

116. *See generally* Jeffrey R. Brown, et al., *Why Don't the People Insure Late Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle*, 98:2 AM. ECON. REV. PAPERS & PROC. (forthcoming Jan. 2008), *available at* http://www.nber.org/~kling/framing.pdf (discussing the perceived value of annuities).

117. U.S. GOV'T ACCOUNTABILITY OFFICE, 401(K) PLANS: POLICY CHANGES COULD REDUCE THE LONG-TERM EFFECTS OF LEAKAGE ON WORKERS' RETIREMENT SAVINGS GAO-09-715, at 2 (2009), *available at* www.gao.gov/new.items/d09715.pdf [hereinafter GAO 2009] (identifying the "standard definition of leakage [as] participants tapping into their accrued retirement savings prior to retirement").

118. GAO REPORT 1996, *supra*, note 90, at 1; *see also* Jefferson, *Striking a Balance*, *supra* note 73, at 535-36.

> Generally, tax qualified defined benefit plans are not permitted to make distributions to employees while employment continues. Either at retirement, or at termination of employment, defined benefit plans are permitted to make payments in the form of lump sum distributions, or in a series of payments over a number of years. In contrast, 401(k) plans are permitted to make distributions of any amount, at anytime during employment, provided the participant has attained the age of fifty-nine and a half, or in the event the participant experiences financial hardship.

Id.

119. SATYENDRA VERMA & JULES LICHTENSTEIN, PENSION LUMP-SUM DISTRIBUTIONS: DO BOOMERS TAKE THEM OR SAVE THEM? 3 (2006), *available at* http://www.aarp.org/research/ppi/econ-sec/pensions/articles/pension_lump_sum_distributions_do_boomers_take_them_or_save_them.html (follow "Data Digest (PDF)" hyperlink) (noting that in 2003, only 44% of those receiving lump sum distributions reinvested the distribution).

120. GAO 2009, *supra* note 117.

121. *See* U.S. GEN. ACCOUNTING OFFICE, CASH BALANCE PLANS: IMPLICATIONS FOR RETIREMENT INCOME, GAO/HEHS-00-207, at 31 (2000), *available at* http://www.gao.gov/archive/2000/he00207.pdf.

122. *See* Rollover Rates, FAST FACTS 1 (Employee Benefit Research Inst.) (Mar. 2000), *available at* http://www.ebri.org/publications/facts/index.dfm?fa=0300fact1.

come taxpayers are more likely to receive smaller distributions when they terminate employment because the value of a participants account is typically a function of compensation and service.[123] When lump sum distributions are not reinvested in other retirement savings instruments, it is far more likely that the funds will be used for non-retirement purposes. As a result, there will be fewer remaining assets to grow tax-free as retirement savings.

Historically, traditional defined benefit plans, second only to Social Security, have been a significant source of annuity income to retirees in this country.[124] Thus, an implication of the shift away from defined benefit plans to section 401(k) plans as primary retirement savings vehicles results in a decline in the availability of annuitized benefit payments.

Therefore, at every stage of the retirement savings process, the shift away from traditional defined benefit plans to 401(k) plans imposes greater risks on low and moderate-income workers. From the decision of whether to make a contribution, to the determination of how to allocate investments, to selections regarding the form of distributions, low and moderate-income workers participating in the increasingly popular 401(k) plans receive neither comparable benefits nor adequate levels of retirement security.

3. The Lack of Insurance Protection in Defined Contribution Plans

Defined contribution plans, including 401(k) plans, are not insured because there has been reluctance on the part of policymakers to insure investment performance, as opposed to the calculable retirement benefits in defined benefit plans.[125] Due to this gap in insurance protection, when market contractions occur close to retirement, participants in defined contribution plans are more likely to experience shortfalls in their retirement benefits than are participants in defined benefit plans. However, the absence of guaranteed minimum benefits has a greater impact on low and moderate-income workers because

123. *See* HEWITT ASSOCIATES, *supra* note 94, at 11.

124. *See What are Workers' Expected Major Sources of Retirement Income?*, FAST FACTS (Employee Benefit Research Inst., Washington, D.C.) Apr. 23, 2009, http://www.ebri.org/pdf/FFE120.23April09.Final.pdf; *see also* GAO Report 1996, *supra* note 90, at 6; Jefferson, *Striking a Balance*, *supra* note 73, at 537.

125. *See* Jefferson, *Defined Contribution Plans*, *supra* note 98, at 617 (discussing absence of insurance protection in defined contribution plans and how participants in defined benefits plans are guaranteed a minimum investment return).

they are less likely to have other assets to make up for investment losses in their retirement accounts.[126]

To protect themselves against such losses, individuals could obtain insurance in the private market. Some insurance and mutual fund companies sell a variety of products guaranteeing a minimum return on certain investments for an annual fee. These instruments provide protection against unexpected fluctuations in the market and other risks that can threaten retirement security as well.[127]

It would seem that reliance on self-help measures such as these does not sufficiently advance the goal of providing retirement security in the private retirement system. Many individuals may fail to obtain protection through no fault of their own. Some employees, especially low and moderate-income ones, may not adequately protect their retirement savings against adverse market conditions because they do not believe they can afford the premiums and fees, or they do not fully recognize the value of such protection.[128]

The amount of insurance needed to adequately protect a retirement account is difficult to determine and depends on unknown factors such as life expectancies, inflation, and investment return. Therefore, many individuals may not be able to determine for themselves how much insurance they need, what a fair rate of return is, or where to go to purchase such products. Accordingly, the trend of using defined contribution plans—401(k) plans in particular—as primary retirement savings vehicles has completely shifted the risk of accumulating insufficient assets for retirement from the employer and the federal government to the participant. This shift has a devastating impact on the retirement security of low and moderate-income taxpayers. In view of the cost and the objective of the private pension system this result is inappropriate.

III. PROPOSAL TO PROVIDE INCREASED RETIREMENT SECURITY TO LOW AND MODERATE-INCOME WORKERS[129]

The existing private retirement system favors high-income taxpayers. The following proposal is designed to increase the participa-

126. *Id.* at 616.

127. Jefferson, *Post-Enron Pension Reform*, *supra* note 76, at 10-42.

128. *Id.*

129. *See generally* Regina Jefferson, Proposal presented at the Re-visioning Retirement Security Conference (Oct. 21, 2009), http://www.retirement-usa.org/about/re-envisioning-

tion rate among low and moderate-income taxpayers in the private retirement system and provide greater protection against benefit losses to all participants. The proposal calls for insured universal personal retirement accounts, with the employee and employer making equal contributions. Contributions for low and moderate-income individuals would be fully or partially subsidized by the government, depending on their income levels. To the extent that the investments of individual accounts conformed to prescribed portfolio parameters for risk exposure, the accounts would be insured by the government and receive a guaranteed minimum retirement benefit. The portfolio parameters would limit the investment risk of individual accounts, but at the same time allow competing investment institutions latitude in portfolio design.[130]

There have been numerous proposals to encourage greater retirement savings among low and moderate-income taxpayers. These proposals have ranged from establishing universal retirement plans to expanding the Saver's Credit.[131] However, the insurance program and the portfolio parameters are the innovative aspects of this proposal.[132] The guarantee places a floor on the account balance received at retirement from a defined contribution plan, based on an average rate of return over a participant's working life. The primary idea of the insurance proposal is to protect participants from severe losses that occur close to retirement, when there is insufficient time for either market corrections or the accumulation of additional personal savings to

retirement-security/proposals-for-a-new-retirement-system/ (follow "Insured Retirement Accounts: Read more").

130. The insurance and the portfolio parameters are based on previous work suggesting an optimal defined contribution insurance program for private sector plans. *See* Jefferson, *supra* note 98. The primary idea underlying the insurance proposal is to protect individuals from severe losses occurring close to retirement age.

131. For example, the Obama administration proposed both a refundable Saver's Credit and automatic enrollment IRAs in its 2009 budget. *Green Book*, *supra* note 1, at 7. The Saver's Credit proposal entails making "the saver's credit fully refundable and would provide for the credit to be deposited automatically in the qualified retirement plan account or IRA to which the eligible individual contributed." *Id.* The proposal also changes the "current 10%/20%/50% credit for . . . contributions up to $2,000 per individual," to a 50% matching for the first $500. *Id.* The administration also proposed that "[e]mployers in business for at least two years that have 10 or more employees . . . be required to offer [either] an automatic IRA option to employees on a payroll-deduction basis," or a qualified retirement plan. *Id.* at 8.

132. The insurance program and the portfolio parameters are based on previous work suggesting an optimal defined contribution insurance program for private sector plans. *See* Jefferson, *Rethinking the Investment*, *supra* note 98, at 649-50; *see also Retirement Security and Defined Contribution Plans: Hearing Before the H. Comm. on Ways & Means*, 107th Cong. 77-84 (2002) (statement of Regina T. Jefferson, Professor of Law, Catholic University of America Columbus School of Law).

make up the difference. The remaining portion of this article summarizes the basic elements of the proposed universal retirement system, and describes the key features of the proposed portfolio insurance program to which the universal retirement system is connected.

A. Basic Elements of the Proposed Universal Retirement System

To ensure that all workers are covered by a private retirement plan, this proposal mandates a universal private retirement system that covers all employees to the extent of wages, up to a limit such as the Social Security Contribution and Benefit Base.[133] The program would be funded by a combination of employer contributions, employee contributions, and a public subsidy for low and moderate-income workers.

At the employer's election, contributions would be made to a clearinghouse established within the Social Security Administration[134] or to an employer-sponsored qualified plan that provides guaranteed benefits. The Social Security clearinghouse would offer the employer a limited choice of pooled investment options, all of which would be guaranteed. The clearinghouse also would be used to maintain benefit records for the program. If the employer opted to contribute to an employer sponsored plan rather than the clearinghouse, the plan would have to be either an individual account plan with a guarantee such as the one described below, or a qualified defined benefit plan.

The Mandatory Universal Pension System (MUPS), recommended by the President's Commission on Pension Policy in 1981, was similar in objective and required a 3% contribution.[135] However, because this amount is unlikely to meet today's standards of adequacy, this proposal requires a 6% contribution.[136] The levels of employer

133. The Social Security Contribution and Benefit Base are a result of the "Old-Age, Survivors, and Disability Insurance (OASDI) program limit[ing] the amount of earnings subject to taxation for a given year," the same limit that applies during benefit computation. Social Security Online, Contribution and Benefit Base, http://www.socialsecurity.gov/OACT/COLA/cbb.html (last visited Jan. 26, 2010). The contribution and benefit base "generally increases [annually, in-line with] the national average wage index." *Id.* The base is $106,800 for 2010. *Id.*

134. Or to some other designated government entity, such as the PBGC.

135. PRESIDENT'S COMM'N ON PENSION POL'Y, COMING OF AGE: TOWARD A NATIONAL RETIREMENT INCOME POLICY (1981).

136. *See, e.g.*, North Carolina Dep't of State Treasurer, *Determining an Adequate Replacement Rate* (2010), *available at* http://www.nctreasurer.com (search "Adequacy Executive Summary", then follow "Microsoft Word—Adequacy Executive Summary" hyperlink) (estimating that "[f]or an employee [making approximately $50,000] who decides to save for . . . 45 years until retirement at the age of 65, the savings rate need only be 10%" to provide for an adequate replacement rate of 42.3% of his pre-retirement income).

and government contributions would be determined by the worker's income, with contributions phasing out as compensation increases beyond a certain level. For those compensated at the lowest levels—for example, the minimum wage—the employer and government would each be required to make a contribution of 3%, and no contribution would be required by the employee. All contributions would be guaranteed and include the cost of insurance. After an employee's compensation reached a certain level, the employee would be required to contribute the full 6% minimum, including the cost of the insurance premiums. Employees wanting to contribute beyond the minimum could do so, up to a limit, entirely at their own expense, including the cost of the insurance premium.

In order to mitigate costs, the program could be phased-in over a period of time. Furthermore, to prevent undue burdens, the employer contribution could be waived for small employers.[137] However, all employers regardless of size would be required to facilitate government and employee contributions to the clearinghouse.

B. Key Features of the Proposed Insurance Program

The proposed insurance program establishes a risk-based, government sponsored insurance program covering all defined contribution plans.[138] The insurance protection described in this proposal is not a guaranteed annual investment return. Rather, the proposed program guarantees a minimum investment return over the working life of a plan participant. The guaranteed minimum benefit is designed specifically to protect a participant against the negative effects of severe market contractions immediately before retirement. Thus, in the event that the market takes a sudden downturn, a participant planning to retire would receive a minimum retirement benefit regardless of her actual account balance.

137. The Department of Labor records pension statistics based upon plans with 100 or more participants versus participants with less than 100 participants. *See generally* U.S. DEPT. OF LABOR EMPLOYEE BENEFITS SECURITY ADMINISTRATION, PRIVATE PENSION PLAN BULLETIN HISTORICAL TABLES (2008). However, in 2004, 36% of U.S. employees were employed by firms with less than one hundred employees. U.S. CENSUS BUREAU, STATISTICS ABOUT BUSINESS SIZE (INCLUDING SMALL BUSINESSES) FROM THE U.S. CENSUS BUREAU TBL.2A, *available at* http://www.census.gov/epcd/www/smallbus.html. Excluding employers with fewer than ten or twenty employees would be more appropriate, as that would exempt employer contributions on behalf of only 11% or 18% of employees, respectively. *Id.*

138. For a more detailed and developed discussion of the insurance portion of this proposal, see Jefferson, *Rethinking the Investment*, *supra* note 98.

1. Use of the Diversification Standard

The proposed program hinges on the use of a prescribed diversification standard. The diversification standard defines an acceptable range of complementary allocations with respect to both investment categories and risk classifications. The standard is designed to approximate an average rate of return for accounts invested in average risk investment instruments, over a participant's working life. To the extent that a participant's insured account complied with the prescribed diversification standard, the account would be protected against the risk of earning less than average investment returns over an employee's career. In connection with the diversification standard, it would be necessary to develop an indexing system to evaluate all investment funds and assign a risk factor to them.

2. Calculation of the Minimum Guaranteed Benefit

An individual's minimum guaranteed benefit would equal the annual employer contributions multiplied by the annual guaranteed rates of investment return for each year of employment. Each year's guaranteed rate of return would be based on the performance of a hypothetical portfolio, assumed to be in compliance with the prescribed diversification standard. The annual guaranteed rate of return would equal the average of the annual rates of return for the hypothetical account, over the prior five years. To diffuse the impact of sudden market fluctuations, the five-year average is used rather than the performance of a single year. This calculation protects both the participant and the insurer against sudden market fluctuations.

The insured benefit would be determined by comparing a participant's actual account balance at retirement age to the hypothetical account balance at retirement. The hypothetical account balance would be determined by using the annual guaranteed rates of return for each year of employment prior to retirement. Thus, the annual guaranteed rates of return effectively establish a floor for the portfolio, below which the retirement benefit would not fall. Accordingly, if the insured portion of a participant's actual account balance fell short of the hypothetical account balance, the insurer would pay the difference. If the participant's actual account balance exceeded the hypothetical account balance, the insurer would retain the insurance premiums.

3. Form and Time of Distribution

The insured benefit would be payable in the form of a life annuity for single participants, and a Qualified Joint and Survivor Annuity for married participants. The benefit would be paid only at retirement age or disability. The retirement age used for this purpose could track the Social Security retirement ages, and could provide for early retirement at age sixty-two. Even if the plan provided for distributions prior to retirement (including loans), there would be no insurance protection available for such events. The restriction against pre-retirement withdrawals not only protects the participant's account against leakage, but also protects the insurer by preventing a single event in the financial market from increasing the volume of insured claims at a given moment as occurred in the savings and loan crisis.[139]

The insured benefit is based on normal retirement age. Therefore, if an individual worked beyond retirement age, the insured retirement benefit would be unaffected by post-retirement-age contributions. However, because the insured benefit would be payable as an annuity, there could be upward adjustments to the benefit for the delay in the annuity starting date. Accordingly, the post retirement age contributions would enhance the annuity, but would not be covered by the insurance program.

4. Structure and Cost of Insurance Premium

Unlike the premium for PBGC insurance, the premium for the proposed program would be risk-based and economically derived.[140]

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139. *See* Jefferson, *Rethinking the Investment*, *supra* note 98, at 667 n.270.

> The savings and loan problem began in 1980 when interest rate legislation was passed which deregulated the liabilities (i.e., deposits), but not the assets of the savings and loan. Soon after, federal tax incentives were introduced in 1981 and 1982 which encouraged real estate projects to be undertaken that were not economically viable. During the same time, the federal government tightened the money supply, which caused government bond interest rates to rise. This situation forced the savings and loans to seek higher short-term rates through junk bonds. Making matters worse, in 1986 oil plunged to $10 a barrel, and the income tax incentives were taken away with no grandfather provisions. Also, one year later the stock market plummeted, and finally in 1989 the Financial Institution's Reform, Recovery and Enforcement Act (FIRREA) imposed higher capital standards on the thrift industry, creating a situation in which more savings and loan institutions had to be seized by the government than had been anticipated.

Id.; *see also* Yakoboski et al., *PBGC Solvency: Balancing Social and Casualty Insurance Perspectives*, 126 Empl. Benefit Research Inst. Issue Brief 18 (1992).

140. Instead, the PBGC has flat-rate premiums. For 2010, the rates are $35 per participant for single-employer defined benefit plans and $9 per participant for multi-employer defined benefit plans. Pension Benefit Guaranty Corp., 2010 Premium Payment Instructions 23 (2010), *available at* http://www.pbgc.gov/docs/2010_comprehensive_booklet.pdf#page=3.

Premiums should be less expensive than they would be if the insurer were private because the government could treat the insurance program as a revenue neutral activity. The level of insurance protection and the cost of the insurance premium would depend on the degree to which the participant's allocation complied with the diversification standard. In order for an account to be fully insurable at the regular premium rate, the participant's account could not be exposed to an investment risk greater than that of the prescribed diversification standard. Thus, the diversification standard resolves the moral hazard problem by placing limitations on the level of risk to which an insured account could be exposed.[141]

CONCLUSION

The tax subsidy for the private retirement system is one of the country's most costly special tax programs. One of the primary objectives of the private retirement system is to encourage individuals who would not, or could not, save on their own to do so. Notwithstanding the size and cost of the retirement program, nearly one-half of the nation's workforce is not covered by a private retirement plan.[142] Those who do participate in such plans disproportionately represent individuals from the highest income brackets. These facts suggest that the existing retirement system is characterized by a redistribution of wealth from low-income individuals, who often have no private retirement benefits, to high-income individuals who maintain private retirement benefits. These facts also suggest that the existing retirement system has not been successful in accomplishing its primary goal.

In recent years, the shift from using defined benefit plans as primary retirement savings vehicles to 401(k) plans has caused even greater variance among taxpayers in different income groups regarding plan participation and the receipt of the tax benefits associated with such programs. As a consequence, rather than encouraging low and moderate-income taxpayers to save, these plans have increased the regressive effect of the overall retirement system. In addition, the

141. A moral hazard is "a hazard that has its inception in mental attitudes . . . [such as the] risk that an insured will destroy property or allow it to be destroyed (usu. by burning) in order to collect the insurance proceeds . . . ." BLACK'S LAW DICTIONARY (8th ed. 2004) (Westlaw). Thus, the tendency of insurance to encourage the source of risk creates a moral hazard problem and presents challenges for designing insurance protection.

142. *See* RETIREMENT PLAN PARTICIPATION, *supra* note 67, at 4 (explaining that in 2006, only 49.7% of private-sector, full-time workers aged 21 and older participated in any type of employer-sponsored retirement plans).

risk allocation in participant directed 401(k) plans disfavors low-income workers and diminishes both the value of their retirement savings and the benefits that they ultimately receive. Unless corrective measures are taken, the increasing popularity of 401(k) plans will serve only to enlarge the disparity of retirement security between high and low-income taxpayers.

Accordingly, additional steps should be taken to ensure greater participation among low and moderate-income taxpayers in the existing private retirement system and to provide greater protection against the risk that use of certain plans as primary retirement savings vehicles presents. These measures are necessary not only to justify the tax expenditure of the retirement program, but also to accomplish its intended purpose.

The universal private retirement system described in Part III of this article is aimed at achieving universal coverage and greater security in the private retirement system by combining a mandatory universal retirement system with a defined contribution insurance program. The universal retirement system provides a subsidy to low and moderate-income taxpayers that phases out as income rises above a certain level. The insurance program protects participants against the risks of plan losses and benefit erosion resulting from market contractions, unexpected longevity, and current consumption. As a result, this program would significantly improve both the equity and effectiveness of the private retirement system in particular, and the overall tax system in general.